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# Discussant's Response to "On the Economics of Product Differentiation in Auditing"

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Good afternoon ladies and gentlemen. First let me express my appreciation to the Symposium organizers for inviting me to start the discussion of such a difficult topic as product differentiation in auditing. I also want to express my appreciation to Dan and his coauthor for making this such a challenging opportunity. It has been a long time since I have thought of differentiation in auditing in terms of formulas like they use. While I have used some advanced mathematical techniques such as regression analysis to determine the reasonableness of inventory levels for a chain of 400 drugstores, it has been many years since I have had to deal with sentences like "Given P′, and a loss from Type I error, all assessed by the user, an optimum audit intensity, N*, can be calculated by performing a Bayesian preposterior analysis."

Many of you are familiar with the television program Star Trek. I want to tell you that after reading the paper several times I could finally sympathize with Dr. McCoy of the Starship Enterprise every time he had to try to treat an injury to Mr. Spock. Dr. McCoy was a very talented physician, but Mr. Spock was a rather unusual character. While, other than his famous ears, he looked human, we know his blood was green and his heart was where your liver might be. His various other physical differences from a normal human being made him quite a challenge to the doctor. I almost feel like I am playing Dr. McCoy to the paper's Mr. Spock.

In spite of these deficiencies in my upbringing, I am going to try to give you what I believe is a practitioner's view on product differentiation in auditing, with particular emphasis on the definition of the product itself. Unfortunately, time did not permit me to discuss the contents of the paper with Dan prior to this meeting. If I had, some of my comments and questions might be unnecessary. But, since our purpose here is to generate a discussion of the paper and its applicability to the world of auditing, I guess we will still be able to meet our objectives.

We should recognize that the academician and the practitioner tend to come at any problem from different perspectives. To paraphrase what they say about the English and the Americans, academics and practitioners are two professions separated by a common interest. I have personally found trying to read and understand most academic papers to be an extremely frustrating experience, especially when the topic seems to have applicability to what I am interested in, but the content leaves me absolutely dumbfounded. I have been heading our firm's audit research and development efforts for the last three years, and have found very few academics that I can discuss audit methodology with who speak a language that I am capable of understanding or applying to our practice. Maybe that is a deficiency on my part, but perhaps it is just symptomatic of the different backgrounds and perspectives of the academician and the practitioner. I do wish there was a more coordinated effort between the academic and practice sides of our common interests that could make much of the research more valuable to the practitioner.

Let me start the discussion of the paper by presenting what I call the Auditor's Dilemma of Interests. The auditor, as we are all painfully aware, really has at least two parties interested in the nature of his services. One of these parties is the client, or client management, that engages the auditor to report on financial statements or render other services as may be required. The other is the public that looks to the auditor as a ''guardian of the public interest.'' Our discussion earlier this morning on the legal liability of accountants touched heavily on this matter.

One of my concerns about the paper is that I believe it tends to deal unrealistically with the public's attitude toward the auditor and the auditor's responsibilities and thus glosses over a major problem of our time. That problem is that the public does not assess *ex ante* and *ex post* probabilities in determining whether, when there has been a business failure, they should try to sue the auditor. Let us be realistic about it. When a business fails, investors have very few sources to look to for recovery of their funds. A legal system such as we have in the United States tends to make it easy for an investor to look for someone associated with the company who has funds to become a target of litigation to recover the lost investment. I do not want to discuss the U.S. legal system, but I believe it is unrealistic to say that, in the real world, only mismatches between the public's expectation of an auditor and the auditor's actual performance on the engagement will result in ''hits'' as they are called in the paper. I believe that, in spite of what the profession would like, the public does perceive the auditor as an insurer of its investment and someone who has the responsibility to signal when that investment might be turning sour.

I believe this has serious implications to the differentiation model when you balance it against the clients who engage the auditor. These clients have interests, too. The paper implies that the client (meaning top management of the client) will always take the position on issues that will most favorably reflect management's wishes as to the outcome of the issue. It almost, but not directly, implies that management will always select a course of action that is opposite the interest of the public when it comes to reporting bad news. While I am sure that such cases do exist, I do not believe it is always the case. Management is not stupid and it does not like to have the auditors waving red flags in front of the bull. Neither management nor the auditor would like to see an auditor's disclosure become a self-fulfilling prophesy. Therefore, it is up to the auditor and the client together to agree that the public interest has been served without destroying the whole economic system because of incomplete and imperfect information.

Thus the auditor's dilemma . . . how does he serve the interests of the client and the public at the same time while serving the other interest which thus far has not been mentioned, that is, the self-interest of the auditor in practice? I believe this is where the issue of differentiation comes into play. It also means it is time that I focused on a definition of the product that the auditor produces.

I believe that the product differs depending upon your point of view. For the public, the product is the auditor's report, and I agree with most of the material in the paper that tends to indicate that the public's only means of assessing the quality of that report is by the reputation, or at least the public's perception of the reputation, of the auditor involved, versus the reputation of auditors as a whole. Of course, the public is working with imperfect information, because even two audit reports signed by the same firm do not necessarily carry the same amount of real quality with them. Auditing firms consist of people, and people do not always react the same way in the face of similar information. So while the general marketing of a firm's name in the public eye is important, I believe it is only important from that standpoint, that is, a marketing standpoint.

The real key to differentiation is to understand that the product the auditor delivers to the client and client management is not the auditor's report. It is the whole relationship of the auditor with the client. It is the auditor understanding what the client expects of him and what is important to that client, and then delivering against those measured objectives.

Differentiation takes on another aspect also. It's a different perspective that the potential client or client has on an auditing firm depending upon whether they are an incumbent firm or whether the company is involved in investigating the engagement of new or different auditors. It is much easier for a firm to differentiate itself in the mind of its client when it has been the firm's auditor for a few years. The incumbent auditing firm knows the client, its strengths and weaknesses, and has hopefully identified any "hot points." The rest of the auditing firms represent a vague world to the client. I think that we have found that the only real way to begin to tickle a potential client's fancy for selecting you as their auditors is to have developed a personal relationship, through outside activities or otherwise, with top management of the potential client. This is why accounting firms devote so much time, effort and expense to the outside activities of their partners. An accounting firm cannot differentiate itself through its audit process nor through anything else that another firm can duplicate. What those other firms cannot duplicate are its individual people and the impressions those people leave in the minds of the clients they serve and the potential clients they contact.

Unfortunately, there is not sufficient time today to provide a detailed discussion of client values, but let me conclude this section of my discussion with a comment: the auditor that does not respond to the client's values, and indeed respond to the client's highest value, will be unsuccessful in attempting to differentiate himself through any of the tools that he uses on the audit. I would propose that the client does not know nor does the client care about the audit process. He does not care if the auditor uses a microcomputer, has a pyramid of six to one or ten to one, or uses yellow or green paper. What he does care about is that he has a good working relationship with an audit partner who really understands his company. That understanding can be demonstrated by being responsive to the company's needs, understanding the company's operations, organization, terminology and management style, and delivering the audit in an efficient manner.

Let me make one more point about responding to client values and differentiation. Good performance in a client value area by the practitioner is usually not sufficient to satisfactorily transfer the differentiation impression to the client's mind. The auditor's exemplary performance in meeting the client's values must be adequately *communicated* so the client is fully aware of the auditor's accomplishments and his efforts to satisfy the client's needs. Remember that attempts at differentiation amongst auditing firms is irrelevant if buyers of the firms' services cannot distinguish the differentiating factors. The auditing firm must transfer the differentiation knowledge to the client and be sure the client acknowledges and is aware of the factors involved. Again, this is much easier for the incumbent firm to do than for a potential auditing firm. In a proposal situation, the client must look to criteria that are indicative of future performance, such as reputation, industry experience and apparent business sense. This is the best alternative available since the client has no actual experience working with the firms being evaluated, except for the limited exposure obtained during the proposal process and any prior personal relationship with the firm's personnel.

In the short time I have, it is not possible to discuss all aspects of the paper, but let me talk about some points that are of the most concern to me. On page 100, the authors conclude that "the higher the fixed cost commitment, the less flexible the firm will be in producing a variety of characteristic vectors." It implies that a firm is less flexible in meeting the real needs of its client and its public if it has more structure to its audit process than another firm. I do not believe this is necessarily true. I believe it depends on the nature of the structure imposed into the process. If those things that are required to be done on every audit, regardless of the shape or size of the company, can somehow be put into a structure so they can be dealt with more efficiently, I believe this gives the structured firm the advantage over one with less structure. Structure does not always have to be viewed in a negative sense. In fact, if the firm can put positive structure into the process, it could actually spend more time doing a better job responding to the client's real values and not have to spend significant amounts of time dealing with constant elements. If the auditor can spend less time on the audit process, of which his client and the public care very little, more time is available for responding to that client's real values which will differentiate the auditor in the client's eyes.

Let me come to the item in the paper that has given me the most trouble. A conclusion in the paper states: "A ranking of audit firms on a credibility dimension has no pejorative implications." Now, to tell you the truth, the first thing I had to do with that conclusion was look up the meaning of "pejorative" in the dictionary. And *Webster's* tells me that means "having negative connotations." What that conclusion says to me is that, if an auditor has a name which is associated with a low credibility level as far as the public is concerned, that does not have any significant implications to that auditor. I may have interpreted the meaning of that conclusion wrong, but if I have not, I find it very difficult to understand. I cannot understand how you can have a negative reputation in the business community as to the quality of the intrinsic value of your report versus someone else's report and it not have implications for your practice or your relationship with your client. During our discussion period, perhaps we can explore whether I have interpreted the conclusion properly and what the implications are for actions that an accounting firm might take in establishing its reputation.

Finally, let me summarize my comments by putting differentiation in what I think is its proper context in the entire auditing process. The auditing firm which does the best job of balancing the three factors that must be considered when providing service to clients—management of risk, efficient conduct and reporting of the audit, and delivering values that are held in the highest regard by that client—is the auditing firm that, in the long run, will be able to differentiate itself from its competition. This differentiation involves hiring the right people and training those people in both the art of auditing and effective communication.